

# OCR Economics A-level

## **Macroeconomics**

### Topic 1: Aggregate Demand and Aggregate Supply

#### **1.3 Aggregate supply (AS)**

Notes

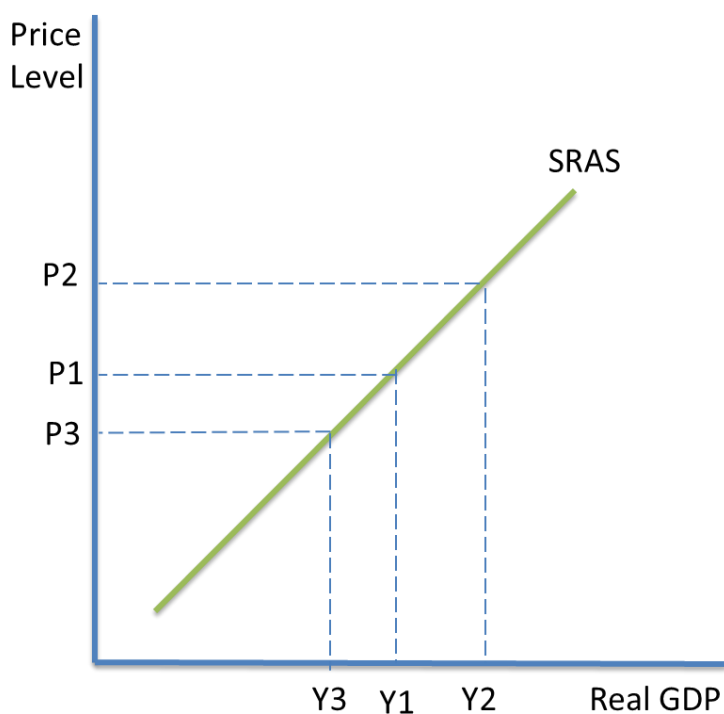
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## Aggregate Supply

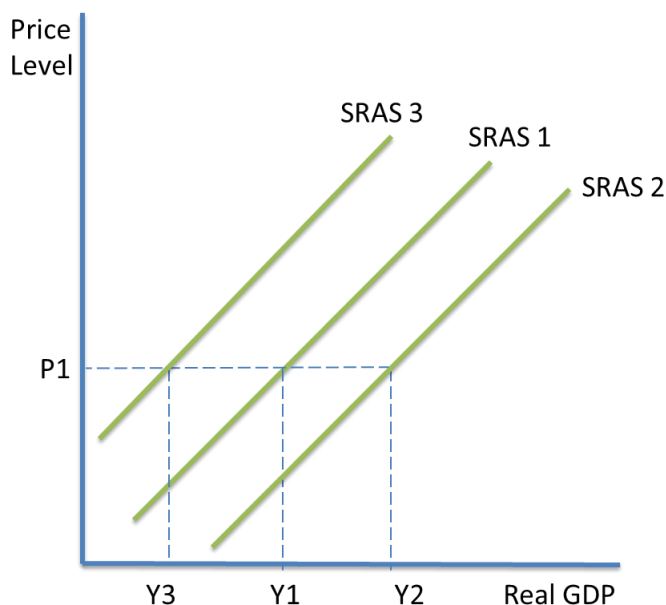
- Aggregate supply shows the quantity of real GDP which is supplied at different price levels in the economy.
- The AS curve is upward sloping because at a higher price level, producers are willing to supply more because they can earn more profits.

## Moving along the AS curve:



- Only changes in the price level, which occur due to changes in AD, lead to movements along the AS curve.
- If AD increases, there is an **expansion** in the SRAS, from Y1 to Y2. If AD falls, there is a **contraction** in SRAS, from Y1 to Y3.

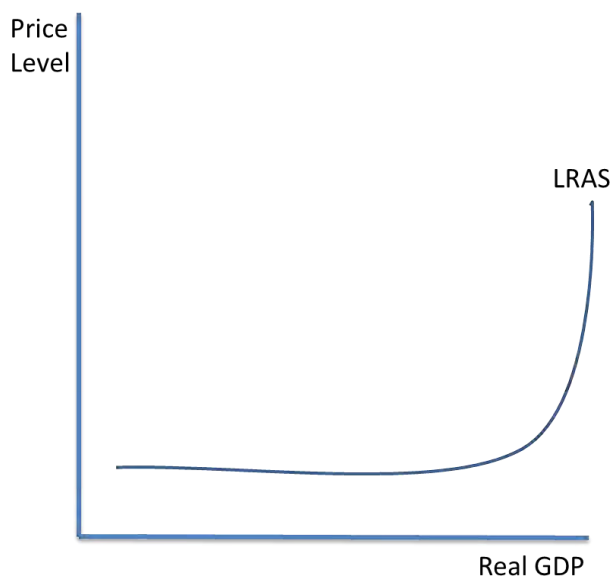




- The SRAS curve shifts when there are changes in the conditions of supply. The price level and production costs are the main determinants of SRAS.
  - The cost of employment might change, e.g. wages, taxes, and labour productivity. If costs increase, supply will shift inwards from SRAS1 to SRAS3.
  - The cost of other inputs e.g. raw materials, commodity prices, and the exchange rate if products are imported. A stronger currency reduces the price of imports, so imported products will be cheaper. This would shift the AS curve outwards, from SRAS1 to SRAS2.
  - Government regulation or intervention, such as environmental laws or green taxes and business regulation. Business regulation is sometimes called 'red tape'.
  - There could be a net outward migration of workers, which causes a 'brain drain' on the domestic economy, as skilled workers move elsewhere.
  - If there is a fall in business capital spending, supply will fall.



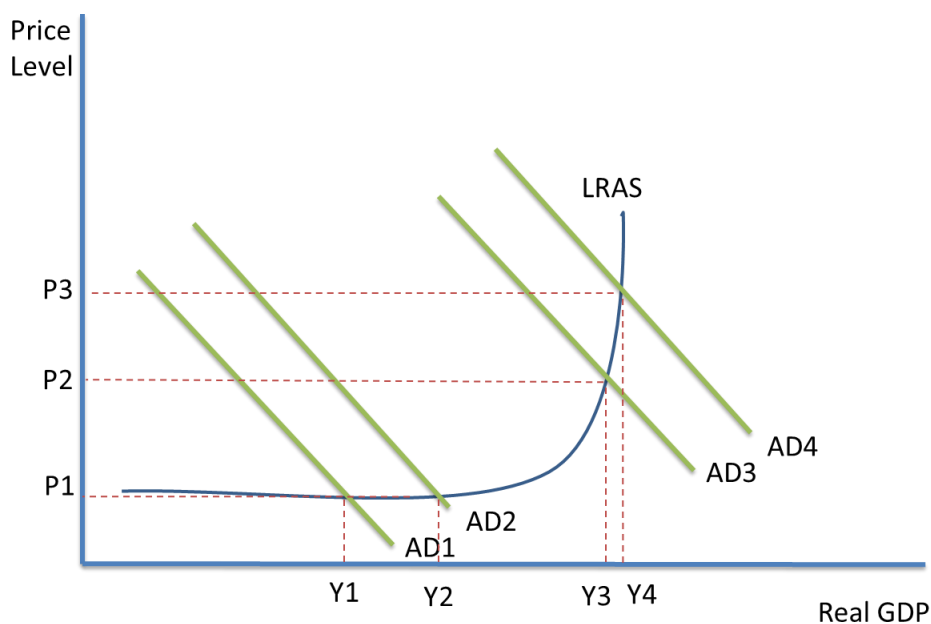
## Keynesian long run AS:



The Keynesian view suggests that the price level in the economy is fixed until resources are fully employed. The horizontal section shows the output and price level when resources are not fully employed; there is spare capacity in the economy. The vertical section is when resources are fully employed.




Over the spare capacity section, output can be increased (AD1 to AD2) without affecting the price level (stays at P1). In other words, output changes are not inflationary.

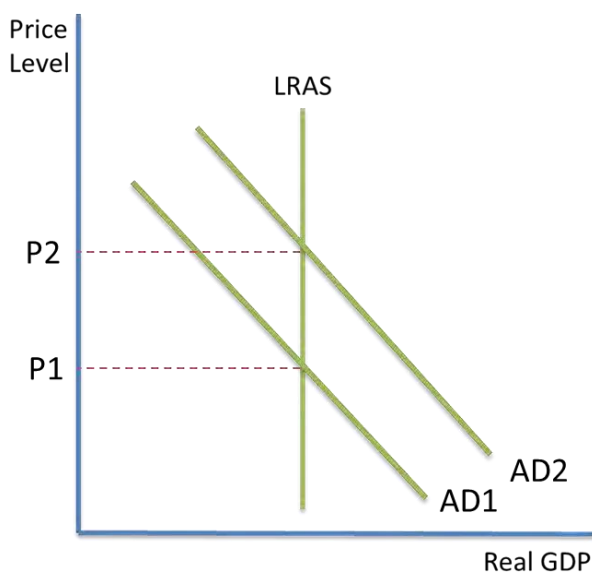
Once resources are fully employed, an increase in output (AD3 to AD4) will be inflationary (price level increases from P2 to P3).



## Neoclassical Aggregate Supply:



-  In the long run, output is fixed at each level and all factors of production in the economy are fully employed.
-  This means that changing AD, such as from AD1 to AD2, only makes a change in the price level (P1 to P2), and it will not change national output (real GDP).
-  The position of the vertical LRAS curve represents the normal capacity level of output of the economy.



### **Factors influencing the long-run AS:**

The LRAS curve is influenced by changes which affect the quantity or quality of the factors of production. This is equivalent to shifting the PPF curve i.e. when the economy is operating at full capacity, and so a change in these factors will shift long run AS. In the long run, we assume that all factors of production are fully employed and changes in price level do not affect aggregate supply.

### **Technological advances:**

If more money is spent on improving technology, the economy can produce goods in larger volumes or improve the quality of goods and services produced.

### **Changes in relative productivity:**

A more productive labour and capital input will produce a larger quantity of output with the same quantity of input.

### **Changes in education and skills:**

This improves the quality of human capital, so it is more productive and more able to produce a wider variety of goods and services.

### **Changes in government regulations:**

Government regulation could limit how productive and efficient a firm can be if it is excessive. This is sometimes referred to as 'red-tape'.

### **Demographic changes and migration:**

If there is net inward migration and the majority of the population is of working age, the size of the labour force is going to be significant, which means the economy can increase its output.

### **Competition policy:**

A more competitive market encourages firms to be more efficient and more productive, so they are not competed out of business. Governments can use effective competition policy to stimulate this in the economy.

